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No. 99-1295

In the Supreme Court of the United States

DAVID A. AND LOUISE A. GITLITZ, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation. During 1991, that corporation obtained a discharge of certain indebtedness. That discharge *would* have been treated as an item of "[i]ncome from discharge of indebtedness" (26 U.S.C. 61(a)(12)) except that, because the discharge occurred when the corporation was insolvent, the item is expressly "not include[d] * * * in gross income" under 26 U.S.C. 108(a)(1)(B). The question presented in this case is whether the amount thus expressly excluded from "income" is nonetheless to be treated as if it *were* an item of "income" which, under 26 U.S.C. 1366(a)(1)(A), flows through to petitioners as the shareholders of the Subchapter S corporation, thereby increasing their basis in the stock of the corporation under 26 U.S.C. 1367(a)(1)(A), and thereby allowing them to deduct losses they previously were unable to deduct because they had exhausted their basis by prior deductions.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-20) is reported at 182 F.3d 1143. The initial opinion of the Tax Court (Pet. App. 25-31) is unofficially reported at 73 T.C.M. (CCH) 3167. The opinion of the Tax Court on reconsideration (Pet. App. 21-24), which withdrew and replaced the initial opinion, is unofficially reported at 75 T.C.M. (CCH) 1840.

JURISDICTION

The judgment of the court of appeals was entered on July 6, 1999. A petition for rehearing was denied on November 3, 1999 (Pet. App. 32-33). The petition for a writ of certiorari was filed on February 1, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. During the 1991 taxable year, petitioners David A. Gitlitz and Philip D. Winn each owned a 50% interest in P.D.W. & A., Inc. (PDW&A), a Colorado corporation that elected to be taxed for that year under the provisions of Subchapter S of the Internal Revenue Code, 26 U.S.C. 1361-1379. Pet. App. 2-3. As this Court explained in *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993), Subchapter S of the Code implements "a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships."

The Subchapter S corporation was a partner in a partnership that was discharged from $4,154,891 in debt during 1991. Pet. App. 3. The corporation's share of this income was $2,021,296, and this amount would have represented "[i]ncome from discharge of indebtedness" to the corporation (26 U.S.C. 61(a)(12)) except that, at the time of the discharge, the corporation was insolvent. Because the corporation was insolvent, this amount was expressly excluded from income under Section 108 of the Code, which specifies that "[g]ross income does not include any amount which * * * would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs when the taxpayer is insolvent." 26 U.S.C. 108(a)(1)(B).

b. Although Section 108 of the Code thus specifies that discharge of indebtness is *not* an item of income for an insolvent corporation, petitioners claim that it should nonetheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax

treatment of shareholders of a subchapter S corporation. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)). The basic concepts reflected in these provisions are: (i) that the income earned (or loss incurred) at the corporate level is treated as if it were earned (or lost) at the individual level; and (ii) that basis adjustments are made to avoid a double tax on those earnings or a double benefit from those losses.

A shareholder may deduct losses only to the extent that he has not previously recovered (through prior deductions) his basis in the stock. 26 U.S.C. 1366(d)(2). In this case, petitioners had previously deducted losses representing their entire basis in the corporate stock. Pet. App. 3-4. At the time the indebtedness of the Subchapter S corporation was discharged in 1991, petitioners would thus be allowed further deductions from continuing corporate losses only if their basis were somehow increased.[1]

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[1] Petitioners had exhausted their basis in the corporate stock by deductions taken in prior years. See Pet. App. 3; 26 U.S.C. 1367(a)(2). The losses of the corporation incurred *prior* to 1991, which petitioners had been unable to deduct because they had exhausted their basis, are described as "suspended" losses and are carried into future years; they may be deducted in future years

Petitioners assert that the additional basis that they need in order to take further deductions from prior corporate losses can be found in the discharge of indebtedness "income" of the corporation in 1991. They assert that this discharge of indebtedness is an "item[] of income" (26 U.S.C. 1366(a)(1)(A)) which increases their basis in the corporate stock (under 26 U.S.C. 1367(a)(1)(A)) even though, for the reasons described above, Section 108(a) of the Code expressly states that this item is "*not*" an item of income. They thus claimed additional deductions in an amount equivalent to their allocable share of the discharged debt of $2,021,296. Pet. App. 3.

Upon audit, the Commissioner determined that petitioners were not entitled to increase their stock basis by their reported *pro rata* shares of the discharge of indebtedness that was "not" an item of income under Section 108 of the Code. The Commissioner therefore disallowed the deductions claimed by petitioners and asserted a deficiency of $251,192 against petitioner Gitlitz and of $242,555 against petitioner Winn. Pet. App. 64-66, 81-83.

2. Petitioners filed separate petitions in Tax Court which were consolidated for disposition. On cross-motions for summary judgment, the Tax Court initially ruled in favor of petitioners. Pet. App. 25-31. The court stated (*id.* at 29-30) that, because income from the discharge of indebtedness is an item of income in the general definition of gross income (26 U.S.C. 61(a)(12)), it qualifies as an "item[] of income" for which an upward basis adjustment is appropriate under 26 U.S.C.

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only if the shareholder acquires a basis in the stock to apply against them. 26 U.S.C. 1366(d)(2).

1366(a)(1)(A) even though, due to the insolvency of the debtor, it is excluded from income under Section 108(a).

The Commissioner moved for reconsideration. While that motion was pending, the entire Tax Court held in a reviewed decision that a discharged debt that is excluded from a Subchapter S corporation's gross income because of its insolvency does *not* constitute an item of "income" that would increase the shareholder's basis in the corporate stock (and thereby allow deductions of losses after that basis has been exhausted by prior deductions). *Nelson* v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999). Relying on its decision in *Nelson*, the Tax Court then granted the motion for reconsideration in this case and entered judgment in favor of the Commissioner. Pet. App. 21-24.

3. The Tenth Circuit affirmed. Pet. App. 1-20.[2] The court of appeals emphasized that petitioners' proposed interpretation of the Code would accomplish an inappropriate double tax benefit for taxpayers: it would permit the insolvent Subchapter S corporation to avoid tax on an item that is "not" treated as an item of income under Section 108(a); at the same time, it would allow the shareholders to reduce their gross income from *other* sources by treating this same item as if it *were* an item of "income," thereby increasing their basis in the corporate stock and permitting deductions otherwise barred by the prior exhaustion of their basis (Pet. App. 10). The court noted that this Court has emphasized

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[2] The taxpayer in *Nelson* v. *Commissioner* also appealed the Tax Court's decision in that case to the Tenth Circuit. The court of appeals affirmed the Tax Court's decision on the authority of its opinion in this case. *Nelson* v. *Commissioner*, 182 F.3d 1152 (1999). The taxpayer in *Nelson* did not file a petition for a writ of certiorari.

that the Internal Revenue Code "should not be interpreted to allow [taxpayers] the practical equivalent of [a] double deduction absent a clear declaration of intent by Congress." *Ibid.* (quoting *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684 (1969)). The court concluded that "only if taxpayers' theory is unequivocally supported by the statutory text may we adopt it here" (Pet. App. 10) and that petitioners did not meet that burden.

The court noted that a discharge of indebtedness does "not" constitute an item of income under Section 108(a) if "the debt is * * * discharged in a bankruptcy proceeding or at a time when the taxpayer is insolvent" (Pet. App. 9) and that this characterization of the item is necessarily made and "applied at the *corporate* level" (*id.* at 11). The court explained that petitioners' effort nonetheless to treat it as an "item[ ] of income" under Section 1366 ignores "the 'price' Congress imposed upon entities whose discharge[] [of indebtedness] income is excluded under § 108." Pet. App. 13. That "price" is set forth in the provisions of Section 108(b), which requires the insolvent corporation to reduce various "tax attributes" (such as carried over credits or losses) "that could otherwise yield future tax benefits." *Id.* at 9. In deciding in Section 108 to "not" treat a discharge of debts owed by an insolvent as "income," Congress did not mean to provide additional tax benefits to the corporate shareholders in the manner proposed by petitioners; instead, Congress determined in Section 108(b) to reduce the preexisting tax carryforwards available to the corporation that might yield "future tax benefits." Pet. App. 9. The court concluded that petitioners' interpretation of these statutes "would negate the effect of the tax attribution scheme and

would give [petitioners] an unwarranted windfall." *Id.* at 16.

DISCUSSION

In Section 108 of the Internal Revenue Code, Congress specified that the discharge of a debt owed by an insolvent corporation does "not" constitute income to that corporation. The Tenth Circuit correctly held in this case that shareholders of an insolvent Subchapter S corporation may not treat the amount that is thus expressly "not" income as if it *were* an "item of income" which, under Section 1366, would increase the shareholders' basis in the corporate stock and allow the deduction of otherwise nondeductible losses. The decision in this case is supported by the recent decision of the Seventh Circuit in *Witzel* v. *Commissioner*, 200 F.3d 496 (2000). But see note 7, *infra*. Both of these decisions, however, directly conflict with the decision of the Third Circuit in *United States* v. *Farley*, 202 F.3d 198 (2000) (Pet. App. 92-124), which expressly declined to follow the decision in this case. See *id.* at 108-109 n.4.[3]

This direct and acknowledged conflict among the courts of appeals warrants review by this Court. The issue that has divided these courts has substantial administrative importance and is frequently the subject of audits and litigation. In addition to the three circuits that have already issued conflicting decisions, the same question presented in this case is already pending in three other circuits. See *Friedman* v. *Commissioner*, 75 T.C.M. (CCH) 2383 (1998), on appeal, No. 98-2378 (6th Cir.); *Gaudiano* v. *Commissioner*, 76 T.C.M.

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[3] We intend to file a petition for a writ of certiorari in *United States* v. *Farley*, *supra*, suggesting that that case be held pending the Court's disposition of this case.

(CCH) 858 (1998), on appeal, No. 99-1294 (6th Cir.); *Pugh* v. *Commissioner*, 77 T.C.M. (CCH) 1367 (1999), on appeal, No. 99-12646 (11th Cir.); *Hogue* v. *United States*, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,149 (D. Ore. Jan. 3, 2000), on appeal, No. 00-35208 (9th Cir.); *Eberle* v. *Commissioner*, 78 T.C.M. (CCH) 366 (1999), on appeal, No. 00-70159 (9th Cir.). In addition, more than 30 other cases raising this same issue are currently pending in Tax Court or in refund suits in federal district courts. These cases are appealable to the various circuits located throughout the Nation in which these taxpayers reside. See 26 U.S.C. 7482(b)(1)(A).

Unless this clear and acknowledged conflict among the circuits is resolved by this Court, the taxation of shareholders of Subchapter S corporations will vary due to geographical happenstance, depending solely upon the circuit in which the taxpayer happens to reside. Review of this recurring issue by this Court is needed to avoid continuing uncertainty and inconsistent application of the revenue laws, and we therefore do not oppose the granting of the petition for a writ of certiorari in this case.

1. Under Section 108(a)(1)(B) of the Code, the discharge of a debt owed by an insolvent taxpayer is "not" included in gross income to the extent of the insolvency. 26 U.S.C. 108(a)(1)(B), (d)(3).[4] As the result, that item is not treated as an "item of income" for any purpose, including for the basis adjustment purposes of Section 1366. Instead of treating and taxing this as an "item of income," the Code directs the taxpayer to use this excluded item to reduce (or eliminate) certain favorable

[4] Section 108 provides the same treatment for the discharge of a debt in a bankruptcy case and for the discharge of "qualified farm indebtedness." 26 U.S.C. 108(a)(1)(A), (C).

"tax attributes" that the taxpayer could otherwise employ to reduce its taxable income in future years. 26 U.S.C. 108(b)(1)-(2).[5] Any debt discharge amount remaining after application against these favorable tax attributes is then to be "disregarded, i.e., *does not result in income or have other tax consequences.*"

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[5] Under Section 108(b)(1), "[t]he amount excluded from gross income under * * * subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." 26 U.S.C. 108(b)(1). Section 108(d)(7)(A) prescribes that, in the case of discharge of indebtedness by an S corporation, Sections 108(a) and (b) "shall be applied at the corporate level." 26 U.S.C. 108(d)(7)(A).

Under Section 108(b)(2), the amount excluded under Section 108(a)(1) is generally applied to reduce the following tax attributes in the following order: (i) any net operating loss for the taxable year of the discharge and any net operating loss carryover to the taxable year of the discharge, (ii) a general business credit, (iii) capital loss carryovers, (iv) the basis of property of the taxpayer and (v) foreign credit tax carryovers. 26 U.S.C. 108(b)(2)(A)-(G). The reductions are dollar for dollar for net operating losses, capital loss carryovers and basis reduction, and 33.33 cents for each dollar excluded under Section 108(a) for the general business credit and foreign tax credit carryovers. 26 U.S.C. 108(b)(3)(A)-(B). Section 108(d)(7)(B) defines an S corporation "net operating loss" for purposes of Section 108(b)(2)(A) as "any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) * * *." 26 U.S.C. 108(d)(7)(B).

Under Section 108(b)(5), "[t]he taxpayer may elect to apply any portion of the reduction referred to in [Section 108(b)(1)] to the reduction under section 1017 of the basis of the depreciable property of the taxpayer." Section 1017(a) provides that if a portion of the amount excluded under Section 108(a) is applied to reduce the taxpayer's basis in depreciable property, "such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs." 26 U.S.C. 1017(a)(2).

S. Rep. No. 1035, 96th Cong., 2d Sess. 2 (1980) (emphasis added).

By thus using the amount of debt discharge excluded from treatment as "income" by the taxpayer's insolvency to reduce certain favorable tax attributes of the corporation, Congress sought to employ Section 108 as a tax-deferral, rather than tax-forgiveness, mechanism: the taxpayer avoids immediate payment of tax from the debt discharge, but pays increased taxes in future years as a result of the discharge. See S. Rep. No. 1035, *supra*, at 10 ("the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge"). In *United States* v. *Centennial Savings Bank*, 499 U.S. 573, 580 (1991), this Court similarly noted that the effect of the exclusion for the discharge of qualified business indebtedness under former Section 108(a)(1)(C) "is not genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the taxpayer's annual depreciation deductions or by increasing the size of taxable gains upon ultimate disposition of the reduced-basis property."[6]

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[6] In *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931), this Court held that a taxpayer realizes taxable income from the discharge of indebtedness. Other courts concluded, however, that the holding in *Kirby Lumber* did not apply to a taxpayer that was insolvent at the time its debts were discharged and remained insolvent after the discharge occurred. See, *e.g.*, *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934); *Astoria Marine Construction Co.* v. *Commissioner*, 12 T.C. 798, 801 (1949) (collecting cases). Under these decisions, the discharge of indebtedness did not represent taxable income for the insolvent taxpayer and had no effect on any of the taxpayer's tax attributes. 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 6.4.6, at 6-58 n.97 (2d ed. 1989). A

2. a. Section 1366(d)(1) limits the aggregate amount of an S corporation's losses taken into account by a shareholder (under Section 1366(a)) to the sum of the shareholder's adjusted basis in the stock of the corporation plus his adjusted basis in any corporate debt owed to the shareholder. Losses that may not be deducted by the shareholder for this reason are described as "suspended" losses; they may be carried forward

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variety of statutory provisions have been enacted, however, to require offsetting adjustments of favorable tax attributes to reflect an insolvent's discharge of indebtedness.

The current statutory scheme was first enacted as part of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2, 94 Stat. 3389. See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 7.6.3, at 7-58 (3d ed. 1999). The original provisions of Section 108 enacted in 1980, however, did not refer to S corporations. In the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 3(e), 96 Stat. 1689, however, Congress amended Section 108(d)(6) to provide that, in the case of S corporations, the exclusion from gross income and the reduction in tax attributes were to occur at the shareholder, rather than corporate, level. Congress reversed itself on that issue, however, in 1984 by enacting Section 108(d)(7), which provides that, in the case of S corporations, the exclusion and the attribute reduction are to take place at the corporate level, and that any (shareholder) loss disallowed for the year of the discharge under Section 1366(d)(1) is to be treated as a net operating loss for that year. Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(b), 98 Stat. 966. The purpose of the 1984 amendment is "to treat all shareholders in the same manner" (H.R. Rep. No. 432, 98th Cong., 1st Sess. 334 (1984)), and Congress envisioned that "the exclusion of income arising from discharge of indebtedness and the corresponding reductions in attributes (including losses which are not allowed by reason of any shareholder's basis limitation) are made at the corporate level" (*ibid.*). Because the 1984 amendment "t[ook] effect as if included in the Subchapter S Revision Act of 1982" (§ 721(y)(1), 98 Stat. 972), the 1982 provisions that would have made the exclusion and attribute reduction operative at the shareholder level were never effective.

indefinitely and deducted in any subsequent year in which the shareholder increases his basis in the corporation's stock or debt. 26 U.S.C. 1366(d)(2).

A shareholder's basis in stock of the corporation is increased by his pro rata share of the "items of income (including tax-exempt income)" of the corporation. 26 U.S.C. 1366(a)(1)(A); see 26 U.S.C. 1367(a)(1)(A). Petitioners claim that the debt discharge, which is "not" income under Section 108(a), is nonetheless an "item of income" of the corporation which increases his basis and allows him to take deductions for losses "suspended" in a prior year because he had previously exhausted his basis by taking other loss deductions.

The court of appeals correctly rejected that claim, not only because it conflicts with the plain language of these provisions but also because it would inappropriately provide petitioners with the "windfall" of a double tax benefit in a context where Congress plainly sought to limit the benefit, not double it. Pet. App. 10.

Petitioners seek to characterize an item as "income" when Congress has instead specified that it is "not" income. Moreover, petitioners do so in an effort to double the benefit of the exclusion of this item from income, for they would use it to increase their ability to take additional, unrelated deductions. But Congress instead carefully specified in Section 108(b) that the benefit of the characterization of this item as "not" income is to be diminished, rather than amplified, by requiring the corporation to make compensating reductions in its favorable tax attributes. See pages 8-9, *supra*. Petitioners' contentions thus conflict with both the text and the obvious spirit of these provisions.

b. In ruling in the taxpayer's favor on this issue in *United States* v. *Farley*, *supra*, the Third Circuit did not dispute that the taxpayer's position would result in

"an apparent 'double tax benefit' for S corporation shareholders." Pet. App. 117. That court also acknowledged that there was strong evidence that the position argued by the taxpayer "may not have been the result intended by Congress." *Id.* at 124 n.10. That court nonetheless concluded that "the clear and unambiguous language" of Section 1366 required it to rule in the taxpayer's favor because, under that provision, "all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation" and thereby "increases the shareholders' basis in their S corporation stock" (Pet. App. 118, 124).

In so holding, however, the Third Circuit failed to take into account (i) that the plain language of Section 108(a) states that the discharge of indebtedness of an insolvent corporation is "not" income (26 U.S.C. 108(a)(1)(B)); (ii) that Section 108(b) requires that item to be applied to reduce the favorable tax attributes of the corporation (26 U.S.C. 108(b)); and (iii) that any remaining balance of that item is then to be "disregarded" and is not to be treated as "result[ing] in income or hav[ing] other tax consequences." S. Rep. No. 1035, *supra*, at 2.[7]

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[7] Section 108(d)(7)(A) provides that, in cases involving insolvent Subchapter S corporations, the amount excluded from the *corporation's* gross income reduces the *corporation's* tax attributes *at the corporate level.* Those attributes include the corporation's net operating loss for the taxable year of the discharge. 26 U.S.C. 108(b)(2)(A). Section 108(d)(7)(B) provides that an insolvent S corporation's net operating loss for the taxable year of the discharge includes its shareholders' suspended losses for that year under Section 1366(d)(1). Under these provisions, the amount excluded from the corporation's gross income under Section 108 remains at the corporate level in order to be available to reduce or eliminate the shareholders' suspended losses; it does not pass

c. The Third Circuit also erred (Pet. App. 111 n.5, 117) in equating the amount excluded under Section 108 with "tax-exempt income," which is encompassed within the items that may pass through to a shareholder and increase the basis of his stock under 26 U.S.C. 1366(a)(1). Although "[t]here is no definition of 'tax exempt' for purposes of section 1366," the term inherently signifies an item that is "exempt on a permanent basis." *Nelson* v. *Commissioner*, 110 T.C. at 125. Thus, items of "tax exempt income" include items such as state and local bond interest and life insurance proceeds, which not only are "not" income in the year received (26 U.S.C. 101, 103) but which are *not* accompanied with the offsetting reductions in tax attributes that make debt discharge income "subject to taxation in the future." 110 T.C. at 125. As this Court explained in *Centennial Savings Bank*, because of the offsetting adjustments of tax attributes required for debt discharge items under Section 108, the result of the

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through to the shareholders to enable them to deduct those losses. *Witzel*, 200 F.3d at 497.

In *Witzel*, the Seventh Circuit agreed with the Tenth Circuit in this case that the amount excluded under Section 108 remains at the corporate level and eliminates suspended shareholder losses for the taxable year of the discharge at that level. 200 F.3d at 497; see note 5, supra. The Seventh Circuit went on, however, in dicta, to state that the amount excluded from the corporation's gross income increased the shareholder's stock basis after eliminating his extant suspended losses. 200 F.3d at 497-498. That conclusion is incorrect. As the language of these provisions indicates, and as the legislative history expressly states, any amount remaining after application against the suspended losses "is disregarded, i.e., does not result in income or have other tax consequences." S. Rep. No. 1035, *supra*, at 2.

statute "is not genuinely to exempt such income from taxation * * * ." 499 U.S. at 580.[8]

When permanently tax exempt items such as state and local bond interest (26 U.S.C. 103) and life insurance proceeds (26 U.S.C. 101) are received by a Subchapter S corporation and passed through to its shareholders under Section 1366(a)(1)(A) as "items of income (including tax-exempt income)," the shareholders receive an *upward* basis adjustment (under Section 1367(a)(1)(A)) that is offset by a corresponding *downward* basis adjustment (under Section 1367(a)(2)(A)) when such income is distributed to the shareholder. 26 U.S.C. 1367(a)(2)(A). As the Tenth Circuit stated in this case (Pet. App. 8-9), the temporary basis increase of such "tax-exempt" items is necessary to *preserve* the tax-exempt character of the income at the shareholder level. In the absence of that basis increase, the

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[8] On December 21, 1999, the Treasury Department promulgated Treas. Reg. § 1.1366-1(a)(2)(viii), which specifies that income excluded under Section 108 is *not* tax-exempt income for purposes of Subchapter S, including the basis adjustment rules of Sections 1366 and 1367. 64 Fed. Reg. 71,643 (1999). The regulation is effective for taxable years beginning on or after August 18, 1998. Treas. Reg. § 1.1366-5.

This new regulation will not resolve the conflict that has developed among the courts of appeals. In ruling against the Commissioner's position in *Farley*, although the Third Circuit suggested (incorrectly) that its position was supported by the reference to "tax-exempt income" in Section 1366(a)(1)(A), the court ultimately concluded that "the nature of discharge of indebtedness income has little relevance" to this case for "[t]he statute is clear—all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation pursuant to § 1366(a)(1)(A)." Pet. App. 118. The court concluded that discharge of indebtedness is an "item[] of income" for purposes of Section 1366(a)(1) regardless whether it is viewed as a tax-exempt or tax-deferred item. Pet. App. 118.

shareholder would be subject to tax upon the distribution of the "tax-exempt" items under Section 1368(b)(2) of the Code, which specifies that any distribution that exceeds a shareholder's adjusted basis in stock is treated as gain from the sale or exchange of property. 26 U.S.C. 1368(b)(2). By contrast, when debt is discharged, there is no distribution in cash or in kind to the debtor Subchapter S corporation, let alone the shareholder. An upward basis adjustment in this context would simply defeat the plain mandate of Congress that the discharge of indebtedness by an insolvent corporation is "not" to be treated as "income" under the Code. 26 U.S.C. 108(a)(1)(B).

d. Petitioners err in claiming that the "plain language" of Section 108(b)(4)(A) of the Code supports their position in this case (Pet. 13-24). Although the Tenth Circuit discussed that provision at some length in its opinion (Pet. App. 14-16), that statute has no bearing on the proper disposition of this case.

Section 108(b)(4)(A) provides a rule with respect to the timing of the attribute reductions mandated by Section 108(b)(1)-(2). The statute provides that those reductions "shall be made after the determination of the tax imposed * * * for the taxable year of the discharge." 26 U.S.C. 108(b)(4)(A). In practice, this means that the amount excluded under Section 108 is not taken into account by the insolvent taxpayer, and results in no reduction of its attributes, until after the tax for the year of the discharge is computed.[9]

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[9] If the taxpayer elects under Section 108(b)(5) first to reduce its basis in depreciable property in lieu of reducing the attributes in the order prescribed by Section 108(b)(2) (see note 5, *supra*), the basis reduction takes effect under Section 1017 on the first day of the taxable year following the year of the discharge. The timing of the basis reduction in the event of this election was chosen "[i]n

The requirement that the reduction in tax attributes under Section 108(b) "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge" (26 U.S.C. 108(b)(4)(A)) applies at the corporate level, not to petitioners as shareholders of the corporation. 26 U.S.C. 108(d)(7)(A). By the express terms of the statute, nothing in Section 108(b) addresses the question whether petitioners may take an amount that is "not" income under Section 108(a) and treat it as an "item[] of income" for the entirely different purposes of Section 1366. Certainly, nothing in Section 108(b)(4)(A) can plausibly be said to be intended to place any taxpayer in a *better* position than he would have been in had the discharge of indebtedness never occurred. As the Tenth Circuit observed in this case, "[t]o embrace [petitioners'] position is to effectively eliminate the 'price' Congress imposed upon entities whose discharged debt income is excluded under § 108" (Pet. App. 13).

3. Petitioners' contention that they "seek equal treatment with other insolvent taxpayers" (Pet. 24) is without merit. The court of appeals properly noted that petitioners are in fact seeking a "windfall"; they are seeking to transmute Section 108 into a double tax benefit that would not be available to any taxpayer *except* a shareholder of an insolvent subchapter S corporation (Pet. App. 10).

Petitioners also err in claiming (Pet. 25) that the "Tenth Circuit has unfairly denied any benefit flowing from the § 108(a) exclusion; it might as well have been taxable income." Petitioners have benefitted from Sec-

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order to avoid interaction between basis reduction and reduction of other attributes * * * ." H.R. Rep. No. 833, 96th Cong., 2d Sess. 11 (1980); S. Rep. No. 1035, *supra*, at 14.

tion 108 because they did not pay any tax, and recognized no "income," on the occasion of discharge of indebtedness of the insolvent subchapter S corporation. The decision in this case merely denies petitioners the *double* tax benefit that they erroneously seek.[10]

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted.

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[10] Petitioners erroneously assert (Pet. 7) that the decision in this case conflicts with the decision in *CSI Hydrostatic Testers* v. *Commissioner*, 103 T.C. 398 (1994), aff'd per curiam, 62 F.3d 136 (5th Cir. 1995). As the Tenth Circuit correctly explained (Pet. App. 19-20), the decision in *CSI* did not involve Subchapter S corporations and has no relevance to this case. Instead, that case concerned whether the amount excluded under Section 108 is includable in a Subchapter C corporation's subsidiary's earnings and profits for purposes of the consolidated return regulations rules concerning investment basis adjustment under Section 1502. That case involves entirely different statutory provisions and furnishes no support for the proposition advocated by petitioners in this case.